Arnór Sighvatsson: Guidelines issued to financial institutions due to non-binding clauses linking loans to the exchange rate

Introduction by Mr Arnór Sighvatsson, Deputy Governor of the Central Bank of Iceland, about guidelines issued to financial institutions due to non-binding clauses linking loans to the exchange rate, Reykjavík, 1 July 2010.

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This morning the Central Bank and the Financial Supervisory Authority issued guidelines to financial undertakings in order to instruct them on how to respond to the Supreme Court judgement on non-binding exchange rate linkage clauses. With these guidelines, the supervisory bodies concerned declare that their unequivocal understanding of the situation resulting from this Supreme Court decision is that, in cases involving loan agreements that have been ruled unlawful, the settlement and repayment of those agreements shall take account of Articles 4 and 18 of the Act on Interest and Price Indexation, no. 38/2001, unless the parties agree otherwise. The guidelines are intended to create stability in financial market transactions and promote a secure and effective financial system. The Financial Supervisory Authority and the Central Bank are required by law to ensure financial system stability, which is a matter of vital public interest. With the issuance of the present guidelines, these institutions are acting in accordance with the legal obligation resting on them.

The guidelines are based on the above-specified supervisory bodies' considered opinion that there is no legal or substantive rationale for the maintenance of the previous interest rates (which were determined with reference to foreign interbank rates) after the portion of loan principal bearing such interest has been uncoupled from the exchange rate of the currency concerned by means of the recent Supreme Court decision. The supervisory bodies are of the opinion that such an interpretation of the Supreme Court judgement, were it implemented to the fullest extent possible, would represent such a heavy blow to financial undertakings' equity that the Treasury would be forced to contribute substantial new capital to them. That expense would ultimately be borne by other members of society.

The method recommended by the Central Bank and the Financial Supervisory Authority will preserve the stability of the financial system even in the event that a majority of loan agreements with exchange rate linkage clauses are deemed unlawful, although it could take quite a long time to determine this conclusively. Financial undertakings' equity will sustain a considerable blow in any case, if judgements by the Supreme Court ultimately extend to a large portion of their loan portfolios. Offsetting this is the fact that uncertainty will have been eliminated, which could provide an opportunity to re-evaluate economic capital at a later time. The financial system should therefore remain sound.

Many borrowers with foreign-denominated loans are in an extremely difficult position. Their anger and disappointment are understandable. It is appropriate to point out, however, that although the method stipulated in the Act on Interest and Indexation is not as beneficial to borrowers with foreign-denominated loans as the continued application of the foreign interest rates set forth in the original loan agreements – which some have demanded – it still improves the position of borrowers considerably, compared to the exchange rate linked loan agreements. Implementation according to the Act on Interest and Indexation therefore represents a compromise: it offers borrowers a more advantageous result than under the original loan agreements while protecting both the public interest and the interests of all debtors and taxpayers, who would have to bear the expense if the most extreme demands of some groups were to be met. The main point is, however, that this approach is enshrined in the law, in the opinion of the supervisory bodies concerned, and is necessary in order to preserve financial stability.

Risk is always present in any nation's financial system, and it can never be totally eliminated. Uncertainty about the interpretation of this Supreme Court decision represents substantial additional risk. The positive side of the situation is that supervisory bodies, the Government, and the legislature can limit this risk to a considerable extent if they respond appropriately.

To simplify somewhat, it can be said that the economic programme pursued by the Government with the support of the International Monetary Fund aims to restore trust: trust in the sustainability of public sector finances, trust in the stability of Iceland's financial system, and trust in the stability of the Icelandic króna. These three elements of trust are so closely intertwined that if one of them fails, the other two are unlikely to remain intact. The past several months have seen a number of positive developments. The króna has appreciated, broad-based fiscal consolidation plan has been implemented, and the reconstruction of the financial system is proceeding apace. We must not sacrifice these improvements for momentary popularity. Consequently, supervisory bodies, governmental authorities, and the legislature must do everything in their power to ensure that these achievements are not squandered.

There is good reason to take a closer look at what is at stake. Many of the world's nations are on the brink of a sovereign debt crisis. Iceland has been among them but is well on the way out of those difficulties. The work this requires is painful but necessary. Substantial additional cost to the Treasury due to a new financial system shock, due to lack of action, would jeopardise the progress that has been made. It would undermine the Treasury's creditworthiness and delay access to foreign credit markets, both for the Treasury and for Icelandic companies, or – at the very least – would affect the terms offered. Access to foreign credit is a prerequisite for export-driven growth. Moreover, deterioration in the banks' position would adversely affect terms in the domestic credit market. Lending rates could rise and deposit rates could decline, impeding investment and delaying economic recovery. As soon as confidence in the Treasury and the financial system erodes, Iceland's currency will suffer as well. In that instance, we would not be able to lift the capital controls as planned, after the Third Review of the IMF programme. Furthermore, the financial system would be poorly equipped to tolerate possible instability associated with capital account liberalisation. Finally, it is appropriate to bear in mind that financial undertakings' scope to meet the needs of other individuals and firms would be drastically reduced.

All of these factors show how vital it is to the public interest that the Central Bank and the Financial Supervisory Authority set forth general guidelines so as to maintain stability while matters of legal uncertainty are being settled. Other authorities and the legislature must also assess whether further measures must be adopted in order to remove all doubt. Ensuring stability is in our hands – all of our hands. We hope and expect that all parties will work together to achieve that goal.